

## **Fixed vs. Variable Rate Mortgage ...**

If you had to pick one rate for the rest of your mortgage life, and your only two choices were a 5-year fixed or a 5-year variable, which would you take?

### **Fixed Rate**

Fixed rate mortgage is a mortgage in which the rate and payments of the mortgage are constant and do not change for the life of the mortgage or its term. The 5 year fix rate is set based on the 5 year bond rate of government of Canada.

#### **Pros:**

- Equal monthly payments over the term of the mortgage

#### **Cons:**

- Usually higher rate and payments comparing to variable rate
- You usually end up paying higher interest over the term of mortgage
- The penalty is calculated as IRD (Interest Rate Differential) or 3 Months interest on the balance of the mortgage whichever is higher. Usually the IRD is more expensive penalty.

### **Variable Rate**

Variable rate mortgage is a mortgage in which the rate and also the payments will change depending on the Prime rate of lending in Canada over the term of the mortgage.

#### **Pros:**

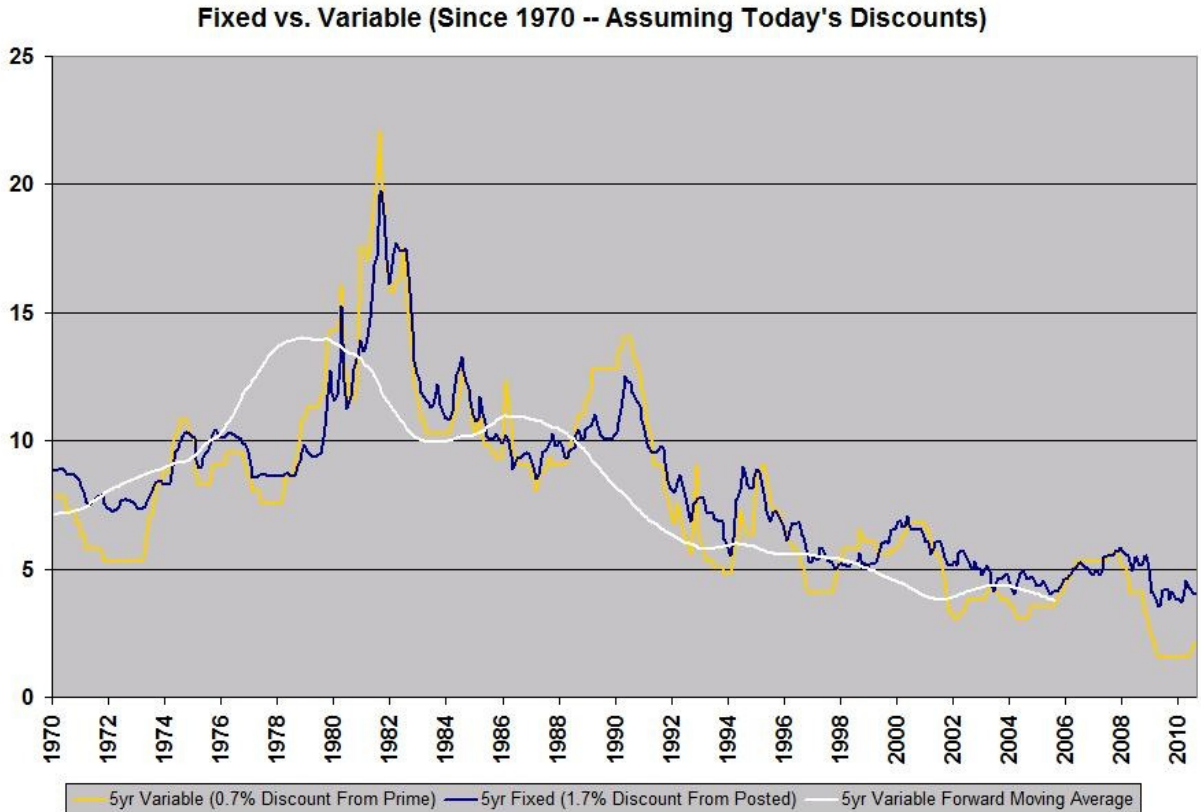
- Lower rate and monthly payments
- Historically lower interest paid over the term of the mortgage
- Always the penalty is calculated as 3 months interest so lower penalty
- Since the penalty is lower you may refinance to lower rate in the middle of the term

#### **Cons:**

- Your rate and payments changes along with Prime over the term – higher risk tolerance needed

## Historically Analysis:

Based on data from 1950 to 2007, the average Canadian could expect to save interest 90.1% of the time by choosing a variable-rate mortgage instead of a fixed. The average savings was \$20,630 over 15 years per \$100,000 borrowed. Those who can negotiate big discounts (0.75% off Prime) save money 77.1% of the time by going variable.



In the above chart, at any given point, the white line shows what variable rates would have averaged over the following five years. This enables a comparison of fixed and variable rates at specific points in time.

The chart shows various times when fixed rates might have performed better than variable rates. That is true even in cases where the fixed rate was notably higher than the variable rate to start. This seems to happen most often just as prime rate starts increasing from a low point in a rate cycle.

## Fix rate mortgage Forecast:

Banks foresee 5-year bond yields climbing to 3.59% by the end of next year. Assuming a typical 1.2 spread above yields, this suggests discounted 5-year fixed rates could rise to roughly 4.79% by year-end 2011.

## **Variable rate mortgage Forecast:**

Big bank economists expect 4.50% prime rate by end of 2011. Based on a .70 average discount from prime, this suggests 5-year variable rates in the 3.8% range by year-end 2011.

## **Conclusion:**

Most mortgage professionals would take the variable, but that doesn't mean 5-year fixed rates are irrational. On the contrary, longer-term fixed rates are quite suitable for borrowers who can't withstand interest rate shocks.

Long story short, variables are still a great bet for many. But, if you:

- Have a tight budget
- Are nervous that prime rate could exceed analyst rate
- Find an amazing deal on a 5-year fixed

...then no one can blame you for paying more for the insurance of a fixed rate.

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